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"Mutation" mink furs were advertised in the paper a few days ago. "Mutation" means "change," and I believe a "mutation" mink fur is one which was not actually produced by minks. In other words, the article was "mink" after the mutation, not before.

Minks — or rather, furs — are not the only things which are changing.

There have been many changes in the accounting profession since its inception in this country around the turn of the century.

One of the great changes has been the improvement in communication — both within the profession and between the profession and other professions and industries. We have a wealth of written material by outstanding authorities on accounting matters, and the leaders of the profession are giving very liberally of their time. We are having local, state, regional, and national meetings. The high regard we have for the ideas of members of other professions was shown very effectively by your approval, evidenced by your applause, of the remarks made by the preceding speaker — a representative from the insurance industry.

Other great changes within the lifetime of nearly everyone here have been the increasing significance of Internal Control to business and auditors, and clarification of the public's conception of the reliance business and auditors place on internal control. This is my subject this afternoon.

DEFINITION OF INTERNAL CONTROL

The Committee on Auditing Procedure of the American Institute of Accountants in 1949 issued a statement with which I know all of you are familiar, on Internal Control. The definition appearing in that statement is as follows:

> "Internal control comprises the plan of organization and all of the coordinate methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies. This definition possibly is broader than the meaning sometimes attributed to the term. It recognizes

that a "system" of internal control extends beyond those matters which relate directly to the functions of the accounting and financial departments. Such a system might include budgeting control, standard costs, periodic operating reports, statistical analyses and the dissemination thereof, a training program designed to aid personnel in meeting their responsibilities, and an internal audit staff to provide additional assurance to management as to the adequacy of its outlined procedures and the extent to which they are being effectively carried out. It properly comprehends activities in other fields as, for example, time and motion studies which are of an engineering nature, and use of quality controls through a system of inspection which fundamentally is a production function."

Note the examples given in the last part of the definition:
"time and motion studies . . . and quality control . . . ."

That definition has been discussed in three articles in *The Journal of Accountancy* during this year (in January issue by Gilbert R. Byrne; in February issue by Saul Levy; and in May issue by Paul Grady). The authors of the first two articles expressed the feeling that the definition is too broad and covers controls not directly related to the accounting records (for example — time and motion studies and quality control), and therefore that it may increase the auditor's exposure beyond the limits ordinarily contemplated.

The author of the last article feels that the concept should not be narrowed, but suggests that internal *accounting* control might be defined within the framework of internal control, and suggests the following definition:

> "Internal accounting control comprises the plan of organization and the coordinated procedures used within the business to (1) safeguard its assets from loss by fraud or unintentional errors, (2) check the accuracy and reliability of the accounting data which management uses in making decisions, and (3) promote operational efficiency and encourage adherence to adopted policies in those areas in which the accounting and financial departments have responsibility, directly or indirectly."

This author states that there are other phases of internal control which the auditor might have to consider, although in areas which "cannot be wrapped up in a neat package." He also points out that an auditor does not need "knowledge or evaluation beyond that required to pass upon the fairness of the financial statements," and thereby implies that the lack of such knowledge, even though such knowledge might be encompassed within the broad definition, would not render the auditor subject to criticism.

In preparing the chapter in the CPA Handbook, over one hundred firms were circularized to determine the current practice in the auditor's review of internal control. Of the large and medium-sized firms which responded, over 75 per cent reported that their review dealt only with business controls which were exercised through accounting procedures and methods, and did not include a review of such matters as standard costs, personnel training programs, and time and motion studies. On the other hand, the small accounting firms were about evenly divided between the use of the narrow and broad concepts of internal control. One of the explanations offered to explain this difference in viewpoint is that the auditor for a small business many times acts as a business consultant, and therefore may be forced to adopt a broader viewpoint.

At some future conference, it could be very worth while to spend some time discussing the "broad" versus "narrow" concepts of internal control.

My purpose in pointing out this divergence in views as to the meaning of "internal control" is not to suggest that we attempt this afternoon to arrive at any definition which would be satisfactory to those here in attendance, but rather, to be certain that we understand that this discussion concerns only controls in those "areas in which the accounting and financial departments have responsibility." We will not concern ourselves with such matters as time and motion studies, quality controls, sales mix, employee training programs, and so on.

GROWING SIGNIFICANCE OF INTERNAL CONTROL

At the outset I mentioned that internal control has been growing in importance. It has received steadily increasing attention by business, and as a result, the auditor has naturally given greater recognition to it in determining the scope of his audit and in rendering his opinion on the financial statements.

What are the reasons for this increase in attention to internal control? The special report of the Committee on Auditing Procedure, mentioned previously, sets forth the reasons as follows:

- The scope and size of the business entity has increased to the point where its structural organization has become complex and widespread. To control operations effectively, management must depend on the reliability of numerous reports and analyses.
- The primary responsibility for safeguarding the assets of concerns and

for preventing and detecting errors and fraud rests on management. Maintenance of an adequate system of internal control is indispensable to a proper discharge of that responsibility.

- The protection which a properly functioning system of internal control affords against human weaknesses is of paramount importance. The check and review which is inherent in a good system of internal control reduces the possibility that errors or fraudulent attempts will remain undetected for any prolonged period and enables management to place greater confidence in the reliability of data.
- It is impracticable for accountants to make detailed audits of most companies within economic fee limitations. Furthermore, a subsequent examination cannot be regarded as a substitute for the exercise of proper controls in the actual handling of transactions.

The foregoing points might be effectively raised when a client resists adoption of the auditor's recommendations for improvements in internal control – that is: (1) that the primary responsibility for safeguarding assets and preventing and detecting errors and fraud rests on management, (2) that proper internal control will increase the reliability of data furnished management, and (3) that some reduction in auditing expense is possible as a result of good internal control.

ESSENTIALS OF EFFECTIVE INTERNAL CONTROL

Internal control was considered in determining the nature and extent of auditing tests over a half-century ago, which is evidenced by *Dicksee's Auditing* of 1905, in which a "general system of internal check" was outlined as including these three things: (1) division of duties, (2) use of bookkeeping proofs, and (3) rotation of personnel.

Would the presence of these three things necessarily result in a system which would satisfy auditors today as being proper from an internal control point of view? Not at all – for the reason that our concept today is much broader.

The special report on "Internal Control" lists four essentials – (1) a proper plan of organization, (2) a system of authorization and recording procedures, (3) sound practices, and (4) qualified personnel.

All four of these elements are necessary in a satisfactory system of internal control – lacking any one of the four, the systems will be defective.

PLAN OF ORGANIZATION

The first of the four requirements was that an organizational structure be created in which functional responsibilities are properly segregated. Custodial, operating, and accounting departments must be independent.

Business today is complex. Production and marketing have become highly competitive, and the techniques necessary in employment, employee training, materials acquisition, handling, fabrication, assembly, and marketing must today be on a more scientific basis than formerly.

Even our smallest clients have found that responsibilities for the various functions of business must be delegated and control must be secured through a system of reports and coordination at check-points, since personal supervision is not practicable.

Independence of the custodial, operating, and accounting departments does not mean that there should be any lack of communication between them.

It *does* mean, however, that no department should control the accounting records having to do with its own operations.

It *does* mean that the records of responsibility for assets (cash, inventories, equipment, etc.), must be maintained by those not having custody of the assets.

For example, it would not be sound for the stores department to keep or have access to the records of accountability for stores. Nor should the handling of funds be a function of the accounting department.

It is evident that the measurement of operating results can usually be expected to be more reliable when the records are developed by those who have no direct interest in the results. Consider piece-work records, departmental bonuses based on profits, comparison with budgets, etc. Even with integrity, it would be impossible for anyone directly interested to be completely objective.

Therefore, a proper segregation of functional responsibilities within the organizational framework is one of the four essentials of every system of internal control.

SYSTEM OF AUTHORIZATION AND RECORDING PROCEDURES

After adopting a plan of organization under which functional responsibilities are segregated, forms and records must be designed for the two-fold purpose of (1) the control of operations through records, and (2) logical classification of transactions in the accounts.

The first step is to develop a chart of accounts which will provide readily obtainable information as to over-all, and departmental, financial condition and results of operations. Controlling accounts will be established where necessary, and a manual of accounts – describing the use of the various accounts – should be developed and placed in the hands of those in the organization who have a part in preparing or summarizing data or records, or who receive financial reports prepared from the records.

A logical system of account numbers with meaningful account captions will, as all of you know, go far toward easy understanding and proper use of the accounts.

Advance planning of the logical flow of media within departments and between departments should result in form design which will provide for summarization of information and authorization and approval points in sequence, with the desirable result of requiring that the prescribed control procedures be followed.

All of us have seen many situations in which full use has not been made of forms which are essential, such as purchase orders, sales invoices, etc. Where there has been such a failure the result is a needless multiplicity of forms – I believe the situation is usually designated as "red tape." While it does not necessarily follow that the controls are less effective in those cases, it will usually be so. This is for the reason that the forms and procedures must be simple enough so that those concerned will thoroughly understand their use and purpose.

Cost systems, budgets, special operating reports, and administrative or operating controls such as sales controls, product controls, etc. are all to be considered as being part of the system of internal control, although some may not be important to the independent auditor, as indicated before.

SOUND PRACTICES

After a plan of organization in which functional responsibilities are segregated, and a system of authorization and recording procedures has been designed, it becomes necessary to effectuate the plan.

Sound practices will give reasonable assurance to management – and to the auditor – that assets are safeguarded, and that fraud and errors are not going undetected for long periods.

No one person – nor one department – should handle a transaction completely from beginning to end. The custody, accounting, and operating functions should be segregated, and when this can not be accomplished, other protective measures must be adopted.

Some examples of sound practices are:

- Rotation of bookkeepers so that no bookkeeper works on his own ledgers in sending statements to customers.

- In a bank, placing dormant accounts under separate control, and permitting withdrawals against such accounts only on officer authorization.
- Proper observation to see that authorized time cards are punched by employees to whom the cards were issued.
- Insistence upon vacations.
- Periodical distribution of payroll by individuals who have no part in preparing the payroll.
- Count tallies on incoming merchandise.

QUALIFIED PERSONNEL

Without qualified people, the system will not operate as desired.

The employer must evaluate each position and find individuals capable of carrying out the prescribed procedures and making the decisions necessary in the position.

Stabilizing the employment is highly desirable, and turnover will be reduced if care is exercised in employing capable people.

Character is important, and particularly where an employee will be in a position in which fraud might be perpetrated, a thorough investigation must be made. The advantages of fidelity bond coverage are well known and not the least among the advantages is the fact that the underwriters nearly always make a careful investigation of the applicant. Such investigations sometimes result in bringing important information to light.

The employee should have explained to him, in addition to his own duties, the over-all plan and the relationship of his work to that of others.

The training of employees should be given careful consideration. On-the-job training by the employee's supervisor, and more formal training in the case of larger concerns, will help to insure a source of capable people with valuable experience as the need develops.

Naturally, it is necessary to make reviews to determine that the work is being carried out as intended.

Many years ago, on one of my first engagements, the client told me that successful business practices could be summarized in three words — "ANALYZE — DELEGATE — SUPERVISE." Much of what I have been saying is covered by those three words.

MANAGEMENT'S RESPONSIBILITY

It is the responsibility of management to provide a system of internal control which will (1) safeguard the company's assets, (2) check the accuracy and reliability of accounting data, (3) promote operational efficiency, and (4) encourage adherence to prescribed managerial policies.

In order to provide this, it is necessary to (1) establish a plan of organization with proper segregation of functional responsibilities, (2) set up an appropriate system of records and procedures, (3) adopt sound practices, and (4) provide adequate and capable personnel.

Management must be continually alert to see that (a) prescribed policies are clearly understood and continue to be carried out, (b) that there have been no changes in the business which would render the procedures obsolete, unnecessary, or inadequate, and (c) that corrective measures are taken immediately when they appear necessary.

THE AUDITOR'S RELIANCE ON INTERNAL CONTROL

Twenty years ago, the standard short-form auditor's report included as a part of the scope paragraph the phrase "have reviewed the system of internal control." The phrase was dropped since it is now widely understood that such a review *must* have been made if the examination was made in accordance with generally accepted auditing standards.

In the special report by the Committee on Auditing Procedure, the second standard of field work is "There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted." When we, as auditors, say in our scope paragraph that our examination was made in accordance with generally accepted auditing standards, we represent that we have made a review of the system of internal control.

While primary responsibility for providing an effective system of internal control rests with management, both the extent and effectiveness of the system are important to the auditor. The following is from Auditing Statement No. 1 (repeated in "Auditing Standards"):

> "The independent auditor must exercise his best judgment in determining the scope of his examination and in deciding whether the interests of stockholders and creditors justify the time and expense involved in the extension of any particular line of inquiry. To a considerable extent, both his selection of the appropriate auditing procedures and his determination of the extent of the tests to which such procedures are restricted are influenced by the reliance he places upon the examinee's internal control. Accordingly, it is the

duty of the independent auditor to review the system of internal control so as to determine the extent to which he considers that he is entitled to rely upon it. To exhaust the possibility of exposure of all cases of dishonesty or fraud, the independent auditor would have to examine in detail all transactions. This would entail a prohibitive cost to the great majority of business enterprises – a cost which would pass all bounds of reasonable expectation of benefit or safeguard therefrom, and place an undue burden on industry."

The independent certified public accountant has as his ultimate objective, in the examination of financial statements, the expression of an opinion respecting the statements.

Since financial statements will be fair presentations if transactions have been properly recorded in accordance with generally accepted accounting principles, it becomes necessary for the auditor to satisfy himself that this has been done.

In every audit, the nature of the examination is affected by relative risk. Cash and negotiable securities are usually subjected to auditing tests more extensive than those applied to, say, real property accounts, even though the values of the latter may be greater, because of possibilities of manipulation in cash and negotiable securities. The auditor may feel that his tests of transactions with officers, stockholders, or affiliated companies should be expanded over what he would have considered necessary if the transactions had been with arms-length parties. In a situation where profits are at an apparently unsatisfactory level, he may decide that tests of inventories, etc. should be enlarged to determine that no inflation of profits is reflected in the financial statements. These are examples of the design of the audit being affected by relative risk.

For the same reason, the pattern of the audit will depend in large measure upon the system of internal control. Where internal control is good, the risk is reduced, and the auditor will be justified in making less extensive tests than where internal control is weak or non-existent.

Both the direction of the auditor's tests, and the extent of his tests, are affected by the auditor's determination of the effectiveness of internal control.

The auditor must base his evaluation of the system of internal control upon his knowledge of the functions and limitations of the procedures employed, and also upon tests made by him to gain assurance that the system is actually operating as planned.

This evaluation can not be completed until the auditor has determined the existence and extent of controls by (a) making inquiry of employees and others as to the procedures in use, and (b) observation of plant, including physical safeguards, material handlings, etc. The auditor must also determine that the system is actually operating as planned, and does so by (a) examination of evidential matter to determine authenticity, points of approval, internal checks, flow of documents, etc., and (b) making tests of selected documents, records, or transactions, to prove the reliability of those selected.

Evaluation – appraisal – of the effectiveness of the system of internal control requires judgment on the part of the auditor. Judgment always requires that proper weight be accorded the various facets of whatever problem is under consideration. In evaluating the system of internal control, if the auditor relies too heavily on inquiry and observation, his conclusions as to effectiveness of the system may be in error; on the other hand, if his inquiry and observation are not sufficiently extensive, he may spend unnecessary time in making tests which are too extensive, and perhaps in the wrong direction.

In the usual situation, the auditor proceeds with his review of internal control as the audit progresses. Every step in the auditing program contributes further to the auditor's knowledge of internal control. The extent of his reliance on the system will change from that originally planned where he finds that the system is not operating as intended.

Consideration must be given as to whether the system of internal control has operated effectively throughout the period, taking into account such matters as lunch-hour relief for employees, vacations, changes in the system or personnel during the period, etc.

The apparent intelligence, competence, and interest, or lack thereof, on the part of employees will be important in the auditor's evaluation of effectiveness of controls.

INTERNAL AUDITING AS A PART OF INTERNAL CONTROL

While it is not usual for a small enterprise to have an internal auditing department, it is not uncommon to find that certain internal auditing functions are being performed by the client's staff. Whenever this is so, the independent auditor should consider the effectiveness of the procedures undertaken in his appraisal of internal control. He must ascertain that the internal auditor is not under control of anyone whose department is being audited. He must give consideration to the apparent degree of competence of the internal auditor.

Even though the independent auditor is satisfied as to the competence and authority of the internal auditor, he must also remember that the objective of the internal auditor is different from that of the independent auditor. The internal auditor's examination is designed primarily to safeguard assets, prevent or detect errors or irregularities, and to ascertain conformity with prescribed accounting procedures. While the independent auditor is interested in these matters, he is concerned principally with the soundness of the judgment of the management as reflected in the financial statements and their conformity with generally accepted accounting principles.

As a result, where internal auditing is being performed, the independent auditor may be justified in reducing the extent of his tests, although he will probably not change the nature of his procedures.

TIME FOR REVIEW OF INTERNAL CONTROL

Except in the very smallest engagements, the review of internal control can be done as interim work prior to the end of the year. In the case of calendar-year closings, this presents a real opportunity for work-spreading, and also gives the client the advantages inherent in an additional visit by the auditor.

An interim examination of internal control may necessitate more total time on the audit inasmuch as it will be necessary to make some tests to determine that the system is still functioning at the audit date, but the disadvantage of such additional time will usually be more than offset by the benefits of the eased year-end work-load of the accountant.

In the CPA Handbook, Chapter 16 on Internal Control mentions the following seven approaches to determination of and recording the existence and extent of controls:

(a) Informal: no written record
(b) Questionnaire approach
(c) Check-list approach
(d) Narrative description approach
(e) Accounting record approach
(f) Organization chart approach
(g) Procedural flow-charts approach.

MAKING A RECORD

Most accountants will agree that it is important to record the results of the study of internal control. Such a record assists the accountant in charge of the audit, and gives the principal a concise but adequate summary of the procedures and resulting control. Last, but not at all unimportant, such a record may someday be necessary to show compliance with generally accepted auditing standards, as Saul Levy points out in the February 1957 issue of *The Journal of Accountancy*.

In very small enterprises, the narrative approach is probably as satisfactory as any method. Those who favor its use in audits of larger concerns feel that in order to use it the auditor must have a more thorough understanding of the system and its operation than might be necessary to simply complete a questionnaire or check list.

The check-list approach has the advantage of suggesting the inquiries which should be made, and will probably usually save time as compared with a review without such a guide. Its proponents claim that it has an advantage over the questionnaire, in that it avoids the temptation to answer questions in a perfunctory way.

Our firm uses a questionnaire which is a guide to the auditor in making his review and also, after being completed, serves as a record of his findings. It is designed so that each page is devoted to one of the major custodial and accounting activities of a business enterprise. Some of the questions merely require a yes or no answer; others require an opinion from the auditor as to the adequacy of controls. The auditor has the advantage of explanatory material on the questionnaire which sets forth some of the more usual means of obtaining control in those areas. Nevertheless, he must *think* in preparing the questionnaire.

The questions are stated so that an affirmative answer indicates a good situation, while a negative answer denotes a weak situation. There is room on the form for additional explanation by the auditor.

After the questionnaire (or any section thereof) has been completed, the auditor is expected to summarize the weaknesses in the system of internal control, setting forth the specific procedures which are not good, and the activities and records directly or indirectly affected, in order that the audit procedures to be used and the extent of tests to be made, can be determined. This is determination of the direction and extent of auditing tests through evaluation of internal control.

The questionnaire also provides space for recommendations which the auditor feels should be made to the client, considering the practical aspects of the situation and obvious limitations imposed by the size of the business. The practice of communicating such recommendations to clients, usually by separate letter, seems to be gaining in favor. The auditor should, of course, be careful that such communications are directed to the proper management level.

INTERNAL CONTROL IN SMALL BUSINESS

In smaller businesses there naturally are limitations on the extent of internal control. Again, relative risk must be considered, and a decision made as to whether proposed procedures reduce risks sufficiently to justify whatever additional expense may be entailed.

Many of the procedures we think of as making up the system of internal control depend upon segregation of duties and are therefore not always available to small businesses. Nevertheless, even the smallest business can have some very effective controls, and if they have not been suggested by the independent auditor, he has not served his client as well as he might. Examples of control found in even the smallest businesses are:

The proprietor of the small business ordinarily will sign all checks; he may open mail and list receipts; control accounts are ordinarily maintained on accounts receivable and accounts payable; an imprest petty cash fund is often maintained; he will usually be familiar with all obligations incurred for purchases; he may keep cash registers under his own control; cash receipts may be deposited intact; customers' invoices may be reviewed by him as to pricing and mathematical accuracy; receiving records will often be maintained; he will be acquainted with all employees personally, and know whether they have been at work during the pay-period; periodic physical inventories will be taken, and so forth.

The auditor will also give proper weight to the probability that, on account of his great interest, the controls may be more effective with owner-review than with employee-review.

CONCLUSION

Increasing emphasis is being placed on internal control by management. This is because management understands that it is primarily responsible for safeguarding assets and preventing and detecting errors and fraud, and further, because the complexities of modern business make it imperative that the data on which decisions are based be reliable.

With the adoption of more effective controls by business and industry, the independent auditor is naturally relying more and more on the effectiveness of internal control in producing financial statements which fairly present financial position, results of operations, etc., in accordance with generally accepted accounting principles.

The independent certified public accountant through his review of internal control for audit purposes places himself in a position to make recommendations for improvements in the controls in use. Making such recommendations constitutes a constructive service, and in many cases will be valued more highly than any other part of the accountant's work.